COSTA RICA

Growth is projected to recover to around 3¼ per cent in 2020 and be broad-based, underpinned by both domestic and external demand. However, uncertainty, particularly surrounding the planned fiscal reforms, is weighing on growth in the near term. The projections are based on the assumption that the fiscal reforms will be implemented from 2019, with modest fiscal tightening holding back growth in 2019 and 2020.

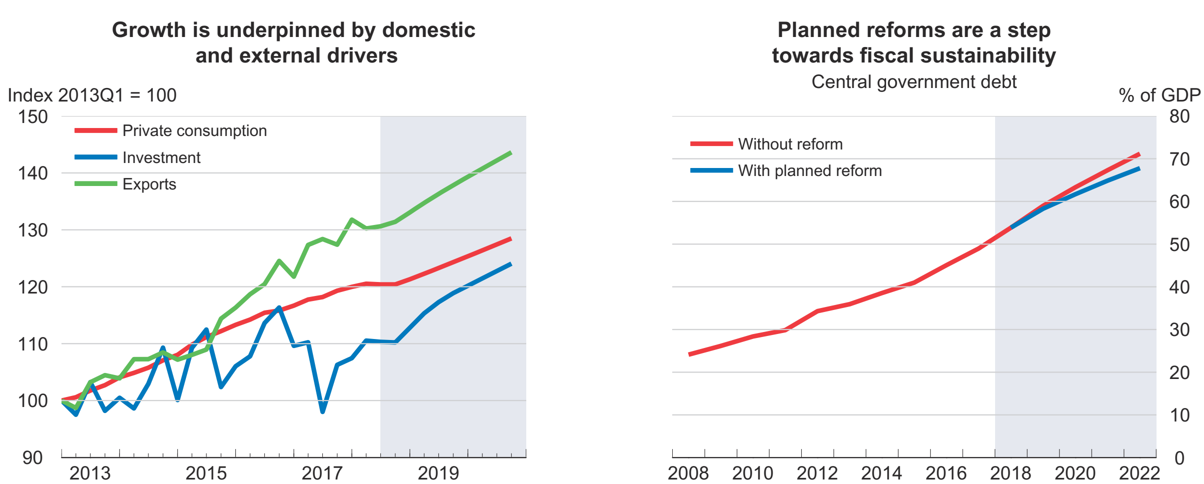
Costa Rica's unsustainable fiscal situation needs to be addressed urgently to avoid a further deterioration in investor sentiment. The fiscal reform bill is an important step in the right direction, but further action will be needed to restore fiscal sustainability. Structural reforms to address labour market mismatches and informality, improve education, lower infrastructure gaps and strengthen competition would boost productivity and reduce inequality.

Growth is slowing but remains broad based

Growth continues to slow as the fiscal situation weighs on confidence and global financial conditions tighten. Strike action in protest of proposed fiscal reforms disrupted public services (particularly education) in September and October 2018, but its impact on private sector activity has largely been confined to retail trade. However, the fiscal reform bill has passed its first reading in the legislative assembly and the projections assume that it will be approved by year-end. While the reform will lower growth in the short term, its effects will be limited by the small magnitude of the consolidation and the low fiscal multiplier. External demand will moderate but remain robust, supported by foreign direct investment and increasingly diverse and sophisticated exports.

Import growth is estimated to have contracted in the second half of 2018 as heightened uncertainty lowered spending on durables. However, private investment is recovering and public investment is projected to increase strongly in 2019 and 2020 due to planned infrastructure projects. Uncertainty has also contributed to recent currency depreciation, and to counter pass-through effects the central bank raised the monetary

Costa Rica



Source: OECD Economic Outlook 104 database; and Costa Rican Ministry of Finance.

StatLink http://dx.doi.org/10.1787/888933876518

Costa Rica: **Demand, output and prices**

	2015	2016	2017	2018	2019	2020
	Current prices CRC trillion	Percentage changes, volume (2012 prices)				
GDP at market prices	29.3	4.2	3.3	2.9	3.0	3.3
Private consumption	19.0	4.0	2.9	2.0	2.1	3.4
Government consumption	5.1	2.3	3.1	1.9	1.7	1.7
Gross fixed capital formation	5.5	4.6	-4.4	3.4	5.9	5.2
Final domestic demand	29.6	3.8	1.6	2.2	2.7	3.4
Stockbuilding[1]	0.0	0.4	0.8	-0.1	0.3	0.0
Total domestic demand	29.6	4.3	2.3	1.7	2.9	3.5
Exports of goods and services	9.0	9.5	5.2	3.8	3.4	4.4
Imports of goods and services	9.3	8.9	2.4	0.4	3.0	4.8
Net exports[1]	- 0.3	-0.2	0.9	1.2	0.1	-0.2
Memorandum items						
GDP deflator	_	2.0	1.9	2.5	3.3	2.8
Consumer price index	_	0.0	1.6	2.0	3.1	2.7
Core inflation index[2]	_	0.1	1.2	2.0	3.2	2.7
Unemployment rate (% of labour force)	_	9.5	9.1	9.7	9.7	9.5
Current account balance (% of GDP)	_	-2.3	-2.9	-2.7	-2.4	-2.2

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 104 database.

StatLink http://dx.doi.org/10.1787/888933877582

policy rate by 25 basis points, to 5.25%, in November. The planned broadening of the value-added tax base will result in a one-off increase in the price level, but inflation is projected to remain within the central bank's 2-4% target range.

Not everyone has benefited from broad-based growth. Inequality has been rising and labour market informality remains prevalent. Unemployment also remains high, reflecting structural mismatches between the skills demanded and supplied as the economy has moved towards more knowledge-intensive activities.

The unsustainable fiscal situation needs to be addressed urgently

Public debt increased rapidly from 24% of GDP in 2008 to 49% in 2017. Without reforms, official estimates indicate that the debt-to-GDP ratio will grow to 71% of GDP by 2022 as the fiscal deficit rises from 6.2% of GDP in 2017 to a peak of 8.3% in 2020. The government's financing options are becoming increasingly limited. In September, the government resorted to 90-day borrowing from the central bank amounting to 5% of the national budget, which is the maximum allowed by law. The planned reforms are positive but further measures to better control public sector payroll costs and reduce budget rigidity stemming from legally mandated spending and earmarking of government revenues are needed.

The fiscal situation presents a major downside risk to the outlook

Although fiscal measures are projected to moderate growth in the near term, the economy is set to recover in 2020, supported by private consumption, investment and exports. However, the unsustainable public debt trajectory represents a large downside risk. If left unaddressed, this will threaten macroeconomic stability and force more drastic consolidation. Uncertainty about when the fiscal reform bill will be approved remains, with a significant risk that it will be delayed. However, if implemented in a timely manner the planned fiscal reform should ease the immediate pressure, although there is a risk that it will not substantially improve the government's financing options given the modest size of the adjustment. On the positive side, the reforms could boost confidence and therefore domestic demand more than anticipated.

Financial volatility in emerging market economies and faster-than-expected monetary policy normalisation in advanced economies could trigger capital outflows that would lead to unanticipated currency depreciation. This presents a risk to financial stability as the Costa Rican banking sector is still heavily dollarised and the majority of dollar-denominated loans are extended to unhedged borrowers. In addition, it would further weaken the fiscal situation, although the favourable currency composition of Costa Rica's sovereign debt would help moderate the effect.

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